CFTC Roundtable

Remarks of Sheila Bair

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Safety and Soundness principles have long applied to banks and bank holding companies and this continues to be the case. Thus in cases where banks have managed their risks imprudently, supervisory action should be taken, regardless of whether the Volcker Rule has been violated.

The Volcker Rule goes farther than basic prudential regulation. It recognizes that certain types of activities are not appropriate inside a banking organization, even if the activities do not otherwise violate safety and soundness requirements.

The problem is, with the repeal of Glass-Steagall, banking organizations are legally entitled to engage in a full range of investment banking, market making, and other activities traditionally conducted by securities firms which used to exist outside of the federal safety net. And it is extreme difficulty to distinguish between these types of functions and "proprietary trading"

Many people do not understand that large banking organizations are made up of many different subsidiaries, some of which take insured deposits and some of which do not. I have advocated that regulators use their powers under the Volcker Rule, as well as their safety and soundness authorities and resolution planning tools, to move "grey area" activities like market making out of the insured bank into one or more separate securities or derivatives affiliates with higher capital requirements applying to these entities, and strict firewalls between them and the insured bank.

Ideally, insured banks would be restricted to traditional commercial banking activities such as deposit-taking, lending, payments processing, and wealth management. These are activities with clear economic value and there is a longstanding public policy interest in having insured deposits support them. This is not to say they cannot also be susceptible to excess risk taking, but they are well understood by management, investors, and bank examiners.

Insured banks will have excess deposits to invest from time to time. This is a particularly acute problem right now as businesses and households have been drawn to the safety of FDIC insured deposits in these uncertain economic times. Banks need to invest these excess deposits if loan demand is insufficient, but those investments should be limited to extremely liquid investments with low credit risk, such as government securities, and extremely high grade, liquid corporate debt.

Market making in derivatives inside of an insured bank would not be allowed, but the use of derivatives to hedge risks in the bank could be permitted if limited to "plain vanilla" products which are centrally cleared.

Inter-affiliate transactions between the bank and securities/derivatives affiliates should be banned, with a possible exception for loans fully collateralized by cash deposits or U.S. Treasuries (subject to a daily mark-to-market) if they are approved by the Fed, FDIC, and bank board.

Guarantees provided by the holding company to any non-bank affiliate should be subordinate to its statutory duty to serve as a source of strength to the insured bank.

I would also require that the insured bank be governed by its own intermediate board and management whose fiduciary obligations are to the insured bank. Money should not be up-streamed from the bank to the holding company to support the activities of other non-bank subsidiaries. Capital levels at the holding company and each operating subsidiary should be at least as high as those required of the insured bank. For securities and derivatives affiliates, the requirements should be higher.

These are the basic principles which I would apply in restructuring large banking organizations to make sure that insured deposits are only used to support economic activity which is understandable and transparent to regulators, investors, and management and has clear economic value.

Now turning to the specific question about the hedging exemption in the current proposed rule, I would dramatically simplify it, as follows:

-Hedges must be identified as such when they are undertaken. The banking organization must also identify the specific risk exposure it is hedging, which must be reasonably correlated to the hedge itself. Both the hedge and the risk being hedged should be publicly disclosed to investors (without disclosing reference names), as well as the expected correlation, the methodology used to determine the correlation, and how the correlation performs over the duration of the hedge.

-Any compensation based on hedging profits should be banned.

By removing employees' financial incentives to make market bets through the guise of hedging, the rule will help assure that risk managers make decisions based on mitigating risk, not generating trading profits. Similarly, transparency and investor scrutiny of a banking organizations' hedging strategies will probably do more to tame excess risk taking than any amount of prescriptive rules.